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June Avoids Swoon to Mark Best Performance in Years

Douglas Coté, CFA
Chief Market Strategist

Markets seem to have become immune to the relentless Armageddon headlines emanating from Greece to China. Investors practically yawned at Greece's near-miss exit from the euro, at the euro-centric G-20 Summit in Los Cabos, Mexico, at China's apparently slowing growth and at a surprise Supreme Court approval of the U.S. health care mandate. Then the 19th Euro Summit at the end of the month charmed the markets, driving the S&P 500 to its best June performance since 1999.

Global risks might have lost their power to scare because the economy, driven by consumers and businesses alike, continues to deliver the goods. Some companies deliver just because they have to, and some realize that extraordinary global opportunities await those that smell success in the face of fear. Regardless of the underlying motives, bold, fearless and unyielding actions form the foundation of capitalism, the global economy's answer to all of its ills.

The market in June has been full of positive surprises, especially in equities, where the MSCI EAFE index had the best returns out of ten broad global asset classes (including fixed income). International stocks were followed closely by global REITs (real estate investment trusts), which locked up first place for the year to date with a stellar return of 17.8% as the bell sounded to end the month. But most investors are so concerned about *downside* risk that they forget that risk cuts both ways. Not owning an important asset class like global REITs is *upside* risk — the risk of missing out on an asset class that goes on a tear.

Executive Summary

- **Ignoring bad news from Greece to China, the S&P 500 posted its best June since 1999.**
- **The MSCI EAFE index led major markets in June; global REITs year-to-date return was 17.8%.**
- **The "Risk Gap" is what investors don't own, which leads to upside risk — forfeiting exceptional returns when mired in "safe" assets.**
- **Normal volatility is the price of earning reasonable compounded returns.**

Returns for a globally diversified strategy over the last ten years refute the notion of a "lost decade"

Index	Wgt	Jun-12	YTD	2011	2010	2009	2008	2007	1 Year	3 Years	5 Years	10 Years
Equity												
S&P 500	10%	3.9	9.5	2.1	15.1	26.5	(37.0)	5.5	5.4	16.4	0.2	5.3
S&P MidCap 400	10%	1.6	7.9	(1.7)	26.6	37.4	(36.2)	8.0	(2.3)	19.4	2.6	8.2
S&P SmallCap 600	10%	4.1	8.0	1.0	26.3	25.6	(31.1)	(0.3)	1.4	19.8	1.8	7.9
Global REITs	10%	4.0	17.8	(5.1)	28.4	36.9	(46.2)	(14.0)	15.5	22.3	(1.7)	8.2
EAFE	10%	6.6	3.4	(11.7)	8.2	32.5	(43.1)	11.6	(13.4)	6.5	(5.6)	5.6
Emerging Markets	10%	3.5	0.6	(22.7)	9.8	93.5	(59.3)	59.1	(22.1)	3.7	(1.7)	17.6
Average		4.0	7.9	(6.3)	19.1	42.0	(42.2)	11.6	(2.6)	14.7	(0.7)	8.8
Fixed Income												
Corporate	10%	0.5	4.7	8.1	9.0	18.7	(4.9)	4.6	9.7	10.6	7.6	6.6
U.S. Treasury 20+	10%	(0.7)	4.3	33.8	9.4	(21.4)	33.7	10.2	37.2	14.1	12.5	9.3
Global Aggregate	10%	0.7	1.5	5.6	5.5	6.9	4.8	9.5	2.7	6.0	6.7	6.5
High Yield	10%	2.1	7.3	5.0	15.1	58.2	(26.2)	1.9	7.3	16.3	8.4	10.2
Average		0.6	4.4	13.2	9.8	15.6	1.9	6.5	14.2	11.7	8.8	8.1
60/40 Porfolio		**2.6**	**6.5**	**1.5**	**15.3**	**31.5**	**(24.6)**	**9.6**	**4.2**	**13.5**	**3.1**	**8.5**

No "Lost Decade"

Source: FactSet and FTSE NAREIT Index

The Risk Gap Is What Investors Don't Own

For the past three years investors have spent enormous time, effort and money trying to figure out what not to own. Most often, investors end up mired in certificates of deposit or a surrogate like short-duration bonds with similarly dismal returns.

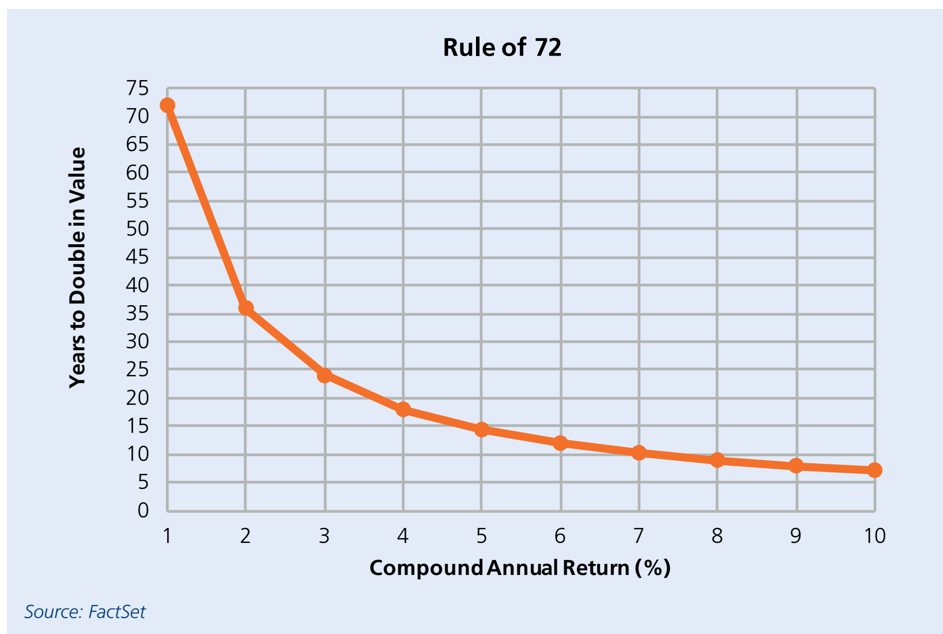
What you don't own can hurt you. The pain takes the form of forfeited extraordinary returns, and you feel it by watching from the sidelines after rationalizing that the investment is too risky. Investors often forget that owning risky assets in proper combinations is the essence of good diversification. To achieve it, we advocate positions in ten asset classes, but the bottom-line goal is always a safer portfolio that can build wealth moderately and dependably over time. Earning respectable returns leverages the most important pillar of investing: the miracle of compounding.

Compound return is the only "free lunch" available to investors, and it works this way. An investor that consistently earns a 1% return will wait 72 years for the portfolio to double in value. At that rate, inflation, even at low levels, will devour the purchasing power. Year after year, an investor or saver in this situation falls further and further behind, with no hope of catching up. But an investor that consistently realizes an 8% return will see his or her portfolio double in value after just nine years. The risk you don't own (like global REITs in 2012) can hurt you, and the solution is to accept and manage the risk — through diversification — rather than avoiding it altogether. Of course, it is very difficult if not impossible to know when a particular asset will break out of the pack, but it is not difficult to own a broadly diversified portfolio. The risk gap is the failure to identify the asset classes you don't — but should — own.

June: A Month of Big Events

- Greek elections increased the risk of an exit from the euro that would have pummeled European banks, potentially ending the euro currency and certainly sending Greece into a depression. New Democracy, the pro-bailout party, narrowly won to avert the crisis.
- The Euro Summit on June 29 took concrete steps toward further political integration intended to make over the region's monetary union into a fiscal and banking union. Global markets roared their approval. The European Stability Mechanism (ESM) bailout fund can now invest directly in banks without any priority in claims status. In late-breaking news, the German parliament approved the fiscal pact and the euro bailout fund.
- China manufacturing data were a disappointment, further exacerbating fears of slower growth and/or a hard landing.
- In a dramatic surprise, most of President Obama's signature health care plan — and the tax/penalty that puts teeth in the individual mandate — were declared constitutional.

Compounding of small increases in returns leads to big increases in wealth



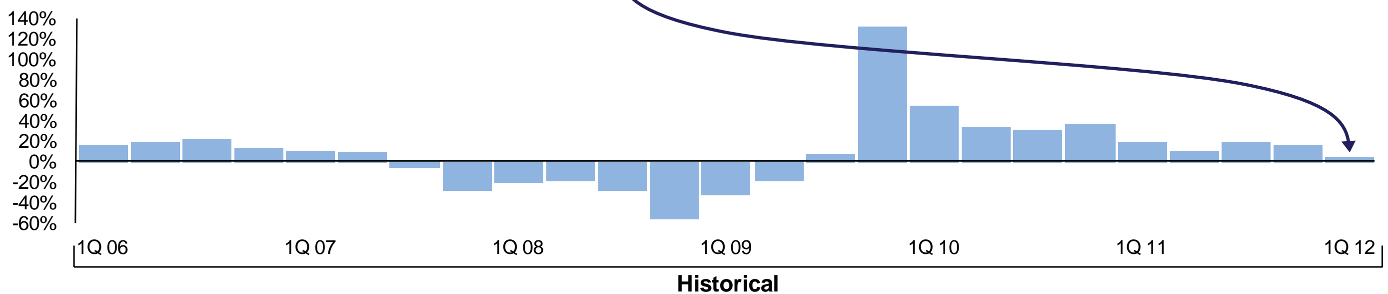
Source: FactSet

Fundamentals Press on Despite Global Risks

- **Advancing corporate profits**. Profits for first quarter 2012 increased 6% on a year-over-year basis, but worried investors have their eye on the second quarter. Earnings growth estimates have ratcheted down from 8.6% at the beginning of the year to an average of 3.1% today.
- **Broadening manufacturing.** U.S. manufacturing stumbled in June. The ISM manufacturing index slipped into contraction territory for the first time since July 2009, falling to 49.7%. The new orders segment posted the biggest drop, primarily attributable to the concern over economic uncertainties in China and Europe. Notably, the significant drop in the price component of the ISM could eventually manifest itself as a corporate sector tailwind.
- **Consumer strength underestimated.** Consumers took a slight breather in May, and April retail sales were revised downward as dire warnings of a global slowdown took their toll on consumer confidence. On the plus side, a big part of the decline in retail sales was due to a dramatic decrease in gasoline prices. In fact, gasoline purchases declined by 2.2% last month. Although aggregate consumer spending was flat, consumer incomes increased in May, and the savings rate ticked up a few notches to 3.9%.
- **Developing economies are driving global growth.** We are accustomed to looking east for economic growth, but what about south? Brazil, once the fastest-growing Latin American economy, has recently slowed and is only expected to grow 2.7% this year. Growth prospects in other Latin American economies are much brighter, though: 5% in Costa Rica and Venezuela, 5.7% in Peru and 8% in Panama. Consumerism reigns, as rising employment and wages are turning the masses into voracious consumers. The 2012 A.T. Kearney Global Retail Development Index ranks four Latin American countries among the top ten for global retail expansion opportunities. Uruguay's retail sales have expanded 30% annually since 2008.

First quarter 2012 earnings reports are complete with positive earnings surprises for 60% of those reporting

Sector	Reported		Earnings Growth			Earnings Surprise		
	Actual	Total	Percent	Positive	Negative	Percent	Positive	Negative
Consumer Discretionary	81	81	3%	48	28	6%	60	13
Consumer Staples	41	41	2%	23	18	3%	31	5
Energy	43	43	-5%	23	18	-2%	24	19
Financials	81	81	19%	54	23	9%	52	22
Health Care	52	52	0%	34	18	3%	36	10
Industrials	61	61	14%	43	16	7%	45	15
Information Technology	70	70	12%	35	35	9%	50	10
Materials	30	30	-8%	14	14	7%	24	5
Telecommunication Services	8	8	3%	4	3	15%	4	4
Utilities	33	33	-7%	10	21	-1%	16	14
S&P 500	500	500	6%	288	194	5%	337	117



Source: Bloomberg, FactSet, Standard & Poor's

Portfolios that remain fully invested through downturns often recover quickly

Average Portfolio Returns (%)
1980-2011

17.2 **13.6** **(10.7)**

1-Month 1-Year 3-Years

Source: FactSet, ING U.S. Investment Management

	U.S. Large Cap	U.S. Small Cap	International	Emerging Markets
Average Returns				
Entire Period Annual (%)	11.5	11.6	10.1	14.6
Average Down Months (%)	(9.9)	(11.4)	(10.4)	(11.1)
Subsequent Returns (%)				
1-Year	14.8	20.8	12.7	20.5
3-Years	11.0	15.8	7.8	19.7

The good news is that the bad news is over-hyped, and the reality is much different than the fear. Among the surprises are two headwinds that have turned into tailwinds: housing and oil. Housing dramatically surprised the market with back-to-back good reports on home sales (up 19.8% year-over-year) and home prices (up 1.7% for May over April). The Brent crude oil price dropped from $125/barrel to $90/barrel in three weeks, a notable miss for those who expected prices to reach $200 at the beginning of the year. Admittedly, slowing global growth concerns are one factor in the declining price of oil; however, it's mainly abundant supply and alternate sources of energy from natural gas fracking that are having an enormous — and unexpected — positive impact.

Broad Global Diversification Benefits from Volatility

Investors were clearly surprised by the resilience of the markets during the month and especially the explosive rally that closed June and the quarter. Maybe "sell in May" was an error this year even though the second quarter ended in the red. That remains to be seen as we enter the summer doldrums, but our view is that enormous rewards are still available in the equity markets.

Our message to investors is that the only way to build wealth is to accept normal volatility as part of the price of earning reasonable compounded returns. The markets in June showed that being in the market matters and that a broad, globally diversified portfolio can build wealth with relatively safe returns. The real risk is foregoing reasonable returns by staying in "safe" cash-like assets that only protect against achieving long-term wealth objectives. ■

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